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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1941.

## Nos. 55-56

THE UNITED STATES OF AMERICA,
*Petitioner,*

*vs.*

ARNOLD W. KRUSE,
*Respondent.*

THE UNITED STATES OF AMERICA,
*Petitioner,*

*vs.*

LESTER A. KRUSE.
*Respondent.*

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

## BRIEF FOR RESPONDENTS.

THE BURT-IORP-WARREN PRINTING COMPANY, 310 S. WEST JACKSON, CHICAGO

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## OPINION BELOW.

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The opinion of the Circuit Court of Appeals for the Seventh Circuit (R. 487-505) is reported in 118 F. (2d) 128.

## JURISDICTION.

The judgments of the Circuit Court of Appeals were entered February 26, 1941 (R. 505-507). The petition for writs of certiorari was filed April 22, 1941, and granted June 2, 1941 (R. 511). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925, and the Rules of Practice and Procedure in Criminal Cases, promulgated by this Court.

## QUESTIONS PRESENTED.

Petitioner states the principal question presented is whether there is a sufficiently definite standard of guilt for the jury to convict, *if any of the distributees rendered any services at all to the corporation* (Brief 2). That question is not presented by the facts in that *petitioner's evidence established that all defendants rendered services to the corporation for which they were paid these commissions.* The questions presented to the court below and presented here are whether or not the trial court erred in refusing to direct verdicts for the defendants and whether the trial court erroneously instructed the jury.

## STATUTES AND REGULATIONS INVOLVED.

The relevant provisions of the statutes and regulations involved are set forth in the Appendix III, *infra*, pp. 62-63.

## STATEMENT.

Continuously from October 1929 up to the time of this trial (September, 1940), the Consensus Publishing Company paid 70% of its net profits weekly to Molasky, Kruse or Kruse, Jr., Ragen or Ragen, Jr., for services rendered to it. These payments were charged on its books, regularly kept, as commissions and taken as a deduction for business expenses in every income tax return of the company. The *sole* basis of petitioner's claim of an attempt or conspiracy to evade the taxes of Consensus is the alleged impropriety of these deductions.

The theory of this case, as it was tried and presented to the court below, was that these commissions were in their entirety distributions of dividends to stockholders, as distinguished from compensation for services rendered.[1]

The principal question presented to the court below was whether or not petitioner's evidence considered as a whole (defendants having offered no evidence) was sufficient to be submitted to a jury. The other question relating to an erroneous instruction need only be considered if the first question is answered in the affirmative.

Petitioner's evidence taken as a whole contains many conflicts. The testimony of some witnesses is inconsistent with the testimony of others; many conflicting hypotheses and inferences can be drawn from this evidence, particularly as to the questiton whether these defendants were in

1. Throughout this record it is frequently stated that the question is whether the sums paid defendants were "dividends" or "commissions". This is a rather loose and confusing terminology. We believe it may be safely stated that where these terms are so used, in contradiction of each other, it was the intention of all parties that the word "dividends" should be construed as a distribution of dividends as such to stockholders of Consensus and not a proper expense deduction, and the term "commissions" should be construed as a payment of compensation for services rendered and a proper expense deduction in the income tax returns of the company. (See Court's Instructions, R. 470.)

fact stockholders of Consensus or held this stock as dummies for Annenberg. There is evidence in the record from which a jury could make either inference. Under these circumstances petitioner failed to meet its burden of proof on this subject. (Appendix II, *infra*, pp. 58-61.)

Petitioner discusses those facts favorable to it; ignores those favorable to defendants; singles out isolated portions of a witness' testimony as establishing a fact and fails to refer to other portions which destroy the very fact petitioner states. One illustration: Petitioner refers to the testimony of one Sweig as establishing that the business was simple, and that the printing of these sheets took but a few hours (Brief 5); Sweig's testimony referred to the character of the business before it was even acquired by Consensus (R. 320, 321). Such facts as are discussed are continuously misstated, loosely stated, or half stated, which enables petitioner without difficulty to draw many unfounded conclusions as a basis for its ultimate conclusion that there was ample evidence to justify the jury's verdict. It is only by considering petitioner's evidence in its entirety that this court can determine whether the court below applied some erroneous "standard of guilt" or whether the court below was guilty of "a flagrant invasion of the province of the jury" as petitioner infers (Brief 20). Petitioner concedes that a reviewing court has the right to determine whether the verdict is supported by substantial evidence (Brief 20).

Under these circumstances it is necessary for us to make a full, accurate and detailed analysis of the facts (Appendix I, *infra*, pp. 35-57). In this analysis we shall endeavor to dispose of petitioner's factual contentions by pointing out its misstatement of facts and unfounded conclusions. We shall state the facts which justified the conclusions of the court below. After analyzing the indictment, we shall refer to certain ultimate facts and then present our argument.

## THE INDICTMENT.

The indictment (R. 2-27) consists of five counts, the first four counts charging an attempt to evade taxes for the respective years 1933 to 1936. These counts allege that Consensus had a gross income for the particular year of a certain amount, was entitled to certain specific deductions under the Revenue Act (omitting all sums paid defendants as commissions for services rendered), had a taxable income upon which a certain tax was due; that to defeat and evade income taxes of a certain specified amount defendants filed an income tax return for the particular year showing a certain gross income, claiming certain deductions (which included the commissions paid), leaving a taxable income of a lesser amount upon which the proper taxes were paid. All items of gross income and deductions claimed by the government to be proper are identical with those set forth on the books of the company and in its income tax returns. **Mathematical computation discloses that the alleged taxes sought to be evaded are arrived at only by the complete elimination of the deductions for these commissions and the allowing to the defendants nothing for their services. None of these counts contains any allegation charging that the deductions for these commissions were improper or why they were improper.**[2]

The conspiracy or fifth count covers all the years in question (1929 to 1936) and is in effect similar to the substantive counts, namely, the taxes alleged to have been evaded exist only by the complete elimination of these commissions paid defendants. We have construed this count to allege that the deductions for these commissions were improper, in that defendants were not employees of

2. These counts contain no allegations to the effect that these deductions "were in fact dividends or distribution of profits" as petitioner asserts on pages 3 and 17 of its brief.

the company and rendered no services to the company but were owners of a beneficial interest therein (stockholders) and the sums paid them as commissions were in fact dividends.[3] Petitioners petition for certiorari states: "Count 5 of the indictment, it is true, alleges that none of the defendants performed any services for Consensus (R. 23)." (p. 15, footnote 9.) Petitioner now claims the indictment contains no such allegation (Brief 15, 31, 33).

The only charge in this indictment, as to any evasion of taxes or conspiracy to evade, was the deduction as a business expense of the commissions so paid defendants. The only allegation as to the impropriety of these payments appears in the conspiracy count. No claim is advanced anywhere by petitioner that these payments were excessive or unreasonable in relation to the value of the services rendered. Petitioner's original position (as reflected by the indictment) was that the defendants rendered no service and therefore all the payments made were improper and wrongfully taken as a deduction in the income tax returns of the company. This was the basis of the alleged attempt and conspiracy to evade the taxes of Consensus.

The Circuit Court of Appeals recognized this and stated:

> "It was directly alleged in the conspiracy count of the indictment and impliedly in the other counts that none of the defendants 'rendered any services to the said corporation'." (R. 502.)

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3. "as the said defendants and each of them then and there well knew, the said defendants (referring to Molasky, Ragen, his son, Kruse, and his son,) would not in fact be, nor were they, employed in an executive capacity or in any capacity whatsoever by the said corporation by virtue of said **'employment contracts'** during the said calendar years 1929 to 1936, both dates, inclusive, nor would they, nor did they, nor any of them, nor any one else for them, render any services to the said corporation by virtue of the aforementioned **'employment contracts'** but that in fact, they, the said defendants, would be, and were, owners and holders of beneficial interests for themselves and others in the said corporation and all of the moneys to be paid and which were paid to them, and each of them by virtue of the said so-called **'employment contracts'** would be and were, in truth and in fact, distributions of profits and dividends from earnings of the said corporation." (R. 23.)

Petitioner on page 31 of its brief takes issue with this conclusion of the Circuit Court of Appeals: correctly asserts that there was no mention made of services in the four substantive counts and further claims for the first time that the conspiracy count alleged only that none of the defendants performed any services for the corporation *by virtue of the so-called employment contracts.* These confusing allegations about employment contracts, services and dividends are negative pregnants. Defendants may well have been employed and rendered services and the deductions of these commissions may well have been proper irrespective of the "employment contracts." If this construction be correct there is nothing to the conspiracy count other than the general allegation of a conspiracy to evade taxes without any facts showing what the conspiracy consisted of aside from the claimed taxes due by the complete elimination of all commissions paid. This count in effect is then similar to the substantive counts.[4]

We urged in the court below and urge here that since the four substantive counts contain no allegations showing wherein the deductions for commissions were improper they set up no cause of action and fall squarely within the ruling of this Court in the case of *U. S.* v. *Cruickshank,* 92 U. S. 542, 557. If the conspiracy count be given the construction now contended for by petitioner it is likewise fatal under the same decision.

Certainly the charges of this indictment are general and allege only that the attempt and conspiracy to evade the taxes of Consensus was by the deduction of commis-

4. Obviously the plain intent of the pleader was to charge that the defendants rendered no services to the company, therefore the deduction of these commissions as a business expense was improper. Petitioner's own evidence having established that defendants rendered services to the company for which they were paid these commissions and petitioner having offered no proof to show that the payments so made were not just compensation for such services; petitioner, in a desperate attempt to avoid this situation, now, for the first time, contends that when it alleged that defendants rendered no services to Consensus, it meant that defendants rendered no services under the "employment contracts."

sions as an expense. Petitioner's theory was that these deductions were improper in that they were dividends as such to stockholders (Brief 3, 17). The burden of proof rested on the government to establish that these deductions were in fact dividends, in whole or in part, that their deduction as a business expense was unlawful and improper and that Consensus owed for the years in question all or part of the taxes claimed.

Petitioner, at the time of the motion for a directed verdict, conceded that before it was entitled to have its case submitted to the jury, its evidence had to establish that Consensus owed the government additional taxes.[5] These additional taxes asserted to be due under the charges of the indictment could arise only if the deductions for these commissions were improper in whole or in part.

Having this burden of proof, under what legal theories could these commissions be dividends and their deduction in the income tax returns of Consensus be improper with the result of additional taxes owed by Consensus:

1. Petitioner claims that they were dividends because they were paid to stockholders in the same proportion as their stock holdings. As pointed out by the Circuit Court of Appeals, this does not necessarily follow and any presumption in this respect would be overcome by proof that services were rendered for which the disbursements were made or could have been made (R. 439). Petitioner does not dispute this legal conclusion of the court below.

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5. "The Court. Well, this jury has got to say, first of all that the income taxes of the Consensus Company haven't been paid.
"Mr. Ziffren: Quite right, your Honor.
"The Court: Yes, that is the first essential.
"Mr. Ziffren: That is right, your Honor. • • •
"The Court: In a civil case we have the very same issue first. The very first issue that the court has to decide in a civil suit is this: Is there a shortage in income taxes? Without reference to its amount, is the method of accounting wrong, has there been a failure to pay the tax which was due? Now, that question is in both cases, in a civil suit as well as in this.
"Mr. Ziffren: Yes, sir." (R. 461).

2. Under the law and treasury regulations these payments, assuming they were paid to stockholders for services, do not constitute dividends unless the payments made were excessive or unreasonable in relation to the services performed. Then only the excessive payments would constitute "dividends."

3. That defendants, the recipients of these commissions, rendered no services to Consensus.

Assuming the conclusion of the Circuit Court of Appeals is correct, before these deductions could constitute dividends, petitioner had to establish either that they were unreasonable compensation or that defendants rendered no services. The last theory was the basis of its indictment, and the theory upon which it proceeded to trial.

## THE FACTS.

We do not propose here to enter into a detailed discussion of the facts and shall only point out the following:

1. Petitioner's evidence established that prior to the organization of Consensus, it was agreed that Annenberg through Cecelia was to own Consensus and that these defendants were to receive these commissions for services to be performed; that the stock of Consensus was incorrectly issued and the defendants were never stockholders of Consensus in the true sense but merely dummies for Annenberg. This clearly appears from our analysis of the testimony of Clark (*Infra*, p. 35) and Famin (*Infra*, pp. 40-49). In Appendix II we review the evidence on this subject and point out that under well established principles of law petitioner's evidence was insufficient to be submitted to the jury on the question whether or not defendants were stockholders of Consensus. The court below was not justified in finding that defendants were stockholders. (R. 499.)

2. Petitioner alleged that none of the defendants rendered services to Consensus for these commissions. Its evidence established that all defendants rendered services to Consensus for which they were paid these commissions. The trial court so found (R. 463) and the Circuit Court of Appeals so found (R. 500, 503). Petitioner did not establish that only some of the defendants rendered services and that the others at the most rendered fragmentary services as petitioner claims throughout its brief. For analysis of this, see Appendix I, heading "All defendants performed services for these commissions." (*Infra*, pp. 50-53.)

3. Petitioner offered no evidence to show that these commissions paid were unreasonable in relation to the services rendered and made no effort to show that the services disclosed constituted the total of those per-

formed. The Circuit Court of Appeals so concluded (R. 500) and petitioner does not question this conclusion.

From this further analysis, assuming our statement of facts to be correct, petitioner failed to prove that these deductions were dividends in whole or in part or that they were improper.

## CONTESTED ISSUES.

Aside from the question as to the sufficiency of the indictment and each count thereof, the issues presented to the court below and to this court are whether or not the trial court erred in overruling defendants' motions for directed verdicts both at the close of the government's evidence and at the close of all the evidence (R. 236); and whether the trial court erred in instructing the jury that the government was only required to prove that a substantial amount of the deductions taken for commissions was improper (R. 471), in view of the fact that the trial court had in effect charged the jury that the vital question in the case was whether those payments *in their entirety* constituted a business expense or a distribution of profits to shareholders. The issue presented to the jury related to the *character* of the deductions as such rather than as to their *amount*.[6]

This case also presents the issue, whether petitioner, in an effort to sustain a conviction of a trial court, can shift its position in this court and advance arguments contrary to those advanced both before the trial court and the court below.

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6. The trial court in its charge stated:
"Now this charge centers about one list of items" (R. 469).
"So it is a vital question in this case of whether the Consensus Company was entitled to deduct from its income the sums distributed to the defendants as ordinary and necessary expenses of its business. The question is whether it should not rather have reported that those distributions were distributions of the profits of the company to its shareholders rather than the payment of compensation to employes and about that this whole case centers" (R. 470).

## SUMMARY OF ARGUMENT.

I. The trial court erred in denying defendants' motions for directed verdicts in that petitioner failed to prove that the deductions in question were improper in whole or in part. Petitioner's evidence established that these commissions were paid defendants for services rendered and petitioner offered no evidence to show that the payments so made were excessive or unreasonable for said services. Petitioner did not establish the allegations of its indictment that defendants rendered no services—its evidence established just the contrary.

II. The case was submitted to the jury on the theory that the deductions of these commissions were either proper or improper in their entirety and that this was the issue in the case. The trial court erroneously instructed the jury that they could convict the defendants if they found only that a substantial portion of these deductions were improper. There was no evidence in the record to support such a finding or instruction.

III. Petitioner's criticism of the opinion of the Circuit Court of Appeals is based on a misstatement of the issues and its own evidence. The factual conclusions of the Circuit Court of Appeals are substantiated by the record. The principles of law which it applied were applicable to these facts. Its ultimate legal conclusions are substantiated by the record.

# ARGUMENT.

## Introduction.

It is extremely difficult to logically follow the sequence and argument in petitioner's brief. We have determined that this brief can best be answered by presenting our theory of this case on the two main issues. This will of itself dispose of many of petitioner's contentions. Under a separate heading, entitled "The Opinion of the Circuit Court of Appeals" we shall dispose of petitioner's remaining contentions.

## I.

**THE TRIAL COURT ERRED IN DENYING DEFENDANTS' MOTIONS FOR DIRECTED VERDICTS IN THAT THERE WAS NO SUBSTANTIAL EVIDENCE SUBMITTED BY THE GOVERNMENT ESTABLISHING DEFENDANTS' GUILT.**

This argument is based on the premise that defendants were stockholders. As a matter of fact, petitioner's evidence was wholly insufficient to justify a finding that defendants were stockholders (Appendix II, *infra*, pp. 58-61). If defendants were not stockholders, there is no question of dividends involved. Assuming defendants were stockholders, it does not follow that the sums paid them were dividends, that the deductions taken were improper, or that Consensus owed any taxes. In this case, the only theory upon which petitioner can seek to justify the verdict of the jury was its original theory, as alleged in its indictment, namely, that defendants rendered no services to Consensus.

After concluding that the defendants were stockholders, the Circuit Court of Appeals said:

"The fact that the disbursements were made to the

defendants in the same proportion as their stock holdings constitutes the Government's major argument that such disbursements were dividends. This does not necessarily follow. *Austin* v. *United States*, 28 Fed. (2d) 677. In fact any presumption in this respect would be overcome by proof that services were rendered for which the disbursements were made or could have been made." (R. 499.)

Petitioner takes no issue with this conclusion. The law and the treasury regulations indicate that the real test, whether sums paid by a corporation ostensibly for services are a proper deduction, is whether the sums paid and taken as a deduction were in fact compensation for services and were in fact reasonable compensation for such services. This rule would apply irrespective of whether the payments are made to stockholders as such, although the question usually arises in small corporations where substantial payments are made to stockholders.[7]

Petitioner does not squarely state the broad proposition that since the payments made defendants were in the same proportion as their alleged stock holdings they constituted dividends as a matter of law—such is not the law. What additional facts does petitioner rely on? The only other facts, which we can find in petitioner's brief which

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7. *Austin* v. *U. S.* (C. C. A. 5), 28 Fed. (2d) 677. *Wm. S. Gray & Co.* v. *U. S.* (C. of C.), 35 Fed. (2d) 968.

Treasury Regulations 19.23(a) 6.—(Reg. 103 Income Tax):

"*Compensation for Personal Services*—• • • The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows: • • • (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, *it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.* • • •

"(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. • • •" (Italics ours.)

it relies on and refers to as "substantial and cogent evidence that the payments in fact were dividends," are those set forth on page 9 of its brief. We shall take them up in turn.

1. Petitioner refers to the fact that the work sheets and weekly reports in certain instances referred to these as dividends.

The record indicates that this was an error on the part of the bookkeepers. (Appendix I, *infra*, pp. 38-39.)

2. Petitioner refers to the fact that Molasky and his niece reported these distributions as dividends from 1933 to 1935.

Molasky from 1929 to 1933 and again in 1936 and the others at all times reported these commissions as compensation for services rendered and paid income taxes on that basis.

3. Petitioner refers to a certain letter from a bookkeeper to Molasky dated December 21, 1933, stating that "no dividend checks would be issued".

It is hard to see how this is binding on defendants, particularly in the light of Government's Exhibit 70, Molasky's reply thereto under date of January 4, 1934, wherein Molasky discusses several other companies wherein he was entitled to dividends and refers to the payments from Consensus as commissions. (Rec. 332.)

4. Petitioner states that Kruse advised the bookkeeper "that the division among the **stockholders** was an arbitrary arrangement (Rec. 342-344)."

If petitioner intends to imply that Kruse used the word **stockholders** the record does not so indicate. It was an arbitrary arrangement. The witnesses testified, "Kruse said it was an amount fixed by Annenberg at the time the company was started". (Rec. 344.)

Does petitioner contend that these facts, when correctly stated, constitute "substantial" evidence that these payments were dividends? None of these facts even remotely tend to show that the sums paid were dividends, or intended to be dividends.

This leads petitioner back to its "major" argument that these payments were dividends because they were paid in the same percentages as stock holdings. This of itself was insufficient. Petitioner, having established that all defendants had rendered services for these commissions, had to further prove that these commissions were unreasonable or excessive.

Section 23(a) of the Internal Revenue Act allows as a deduction,

> "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services rendered." 26 U. S. C. A. (23a).

It logically follows that the deductions of these commissions, as a business expense in the income tax returns of Consensus, were only and could only be improper (dividends under petitioner's theory) if the amounts paid were excessive or unreasonable in relation to the services rendered. But this is not a civil case, it is a criminal case. Respondents in the court below urged that under the case of *United States* v. *Cohen Grocery Co.*, 255 U. S. 81, and similar cases that petitioner could not establish a crime by merely proving (which it did not) that the commissions paid were unreasonable in relation to the services rendered; that petitioner did not prove that defendants rendered no services; and that the only other possibility of attack against these deductions would be a claim that the deductions were so unreasonable in relation to the services rendered as to constitute a fraud. Respondents then pointed out that there was no such evidence in the record.[8]

8. From our brief in the court below (page 46):

"In the light of the above cases (referring to the Cohen Grocery case, et al.), the government *in a criminal case* cannot establish a crime by merely proving (which it did not) that the commissions paid and taken as a deduction were unreasonable in relation to the value of the services rendered. It had to prove by substantial evidence beyond a reasonable doubt that these deductions were improper for some other or different reason. The indictment alleged that the de-

As stated by the Circuit Court of Appeals:

> "There was no proof and no effort by the government to show that the services disclosed constituted the total of those performed and no effort to show the reasonable value of such services," (Rec. 590).

Petitioner does not dispute this statement. It offered no evidence to prove that the payments of these commissions were excessive or unreasonable in relation to the services rendered, if this of itself be sufficient. It certainly offered no evidence to show that the commissions paid were so disproportionate to the services rendered as to constitute a fraud. It follows that petitioner's proof did not therefore show that these deductions were improper, in whole or in part, under the theory that they were unjust compensation for services rendered or that they were dividends. By the same token, petitioner did not prove that Consensus owed the Government any taxes in whole or part for the years in question. Before there could be a crime there had to be a tax liability; petitioner established none.

Under petitioner's evidence, the only remaining basis, for a claim that these deductions were improper, was the one first advanced by petitioner, namely that the defendants rendered no services for the sums paid them. This was the theory of the indictment, conspiracy count only, and petitioner's proof showed just the opposite.

Petitioner, faced with this record at the time of the motions for directed verdicts, took the position that the question of services and their value was immaterial. It argued that its evidence was sufficient to go to the jury on the broad

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ductions were improper in that the defendants rendered no services to the company. Not only did the proof fail to establish this fact but it established just the contrary. The only other possibility of attack against the deductions in question would be, a claim that the commissions paid were so disproportionate to the value of the services rendered as to *prima facie* constitute a fraud. There is no such evidence in the record. The Government failed to prove these deductions were improper—hence failed to prove the first requisite of their case, viz., that there were any taxes due from Consensus."

question whether or not these deductions as such constituted dividends or commissions. The trial court then permitted the case to go to the jury on this theory only. See colloquy of court and counsel (Rec. 457 to 466). The only issue presented to the jury was whether this item of deductions constituted dividends as such or represented compensation for services (Rec. 470-471).

Petitioner in the Circuit Court of Appeals sought to sustain these judgments on the same theory. Petitioner admitted that this item of deductions must be treated as dividends in their entirety and if so unlawful deductions, or as commissions in their entirety and therefore proper deductions,—that there was no middle ground (Rec. 502). For discussion of this see *infra*, pp. 24-25.

Petitioner's theories, upon which it was permitted to submit its case to the jury, and which it urged in the court below to sustain these judgments, was that the question of services and their value was immaterial in that these deductions were either dividends in their entirety or compensation for services. These theories were advanced because of the deficiencies in the record. Petitioner here shifts its position. It misstates the record as to the services performed by all defendants and claims that its evidence established that certain of the defendants rendered *no* services. It then urges in this court for the first time that its theory of this case was and is that part of these deductions were dividends and part were commissions and the jury was justified in so finding (Brief 32-33). Petitioner should not now be permitted to shift its position. *Helvering* v. *Wood*, 309 U. S. 344, 349.

Petitioner on page 19 of its brief refers to certain facts as amply supporting the verdict of the jury. We discuss these in turn:

1. "The essential operations of the company were

simple and were carried on largely by part time employees."

This is based on the testimony of Sweig as to condition of the business prior to the time it was acquired by Consensus. (Rec. 320-321.)

2. "The fact that at least some of the defendants rendered no services at all, or at best, only fragmentary services."

This is not the fact. Appendix I, *infra*, pp. 50-53.

3. "The fact that all the profits of the enterprise were distributed weekly in exact proportion to stock ownership."

This does not establish as a matter of law that these commissions were dividends. Any presumption which might attach thereto is destroyed by other factors in the case. *Supra*, pp. 14-15.

4. "The fact that the bookkeepers worksheets and weekly reports in certain instances referred to these disbursements as dividends."

This is answered. Appendix I, *infra*, pp. 38-39.

5. "The fact that Molasky and his niece actually reported the disbursements as dividends."

This has been answered. *Supra*, p. 16.

6. "The fact that the defendants participated in the destruction of critical documents and in the execution of spurious predated contracts of employment."

This is answered. Appendix I, *infra*, pp. 48-49.

On these facts petitioner concludes that all these

> "furnish overwhelming support for the jury's conclusion that the 'commission device' was wilfully employed as a means for distributing corporate earnings."

These are the only facts most of them unsupported in the record that petitioner can gather from this record to sustain the verdict of the jury. Does it consider these facts "substantial"?

Under the law and the facts, the petitioner's evidence was wholly insufficient to be submitted to the jury. The Trial Court erred in refusing to direct a verdict for the defendants, both at the close of petitioner's case and at the close of all the evidence.

## II.

### THE TRIAL COURT ERRONEOUSLY INSTRUCTED THE JURY

After instructing the jury that its charge centered about one list of items; that they were to determine whether the sums so paid as commissions were in fact paid for services rendered or were in fact paid as a distribution of profits or dividends, and that about this the whole case centered, the Trial Court, over defendants' objections erroneously advised the jury in part:

> "* * * It is for you to decide whether these were, *or whether a substantial portion thereof*, was a distribution of profits rather than the compensation of employees.
>
> I use the words 'these sums *or a substantial portion* thereof'. It is not necessary for the government under this indictment to prove that all of the sums so distributed to these defendants were profits. * * * It is sufficient if you find beyond a reasonable doubt that the defendants intentionally diverted profits of this concern, in the amounts charged in the indictment *or substantial parts thereof*, diverted them from the form of profits and received them in the form of commissions. That, as I said, comes back always to the ultimate question that you have got to decide." (Rec. 471. (Italics ours.)

Petitioner states that

> "viewed as a whole, as of course it must be, the charge was exceedingly thorough and fair." (Brief 33.)

While the Circuit Court of Appeals indicated that considered in the light of the entire charge "this particular portion of the charge appears less harmful," we submit that, when considered in connection with the entire charge, its erroneous character is magnified.

The Trial Court did not comment on the facts and its instructions were of a most gereral nature. The Trial Court had previously instructed the jury that the case

centered about *one list of items*, that is, of course, the deduction of these commissions; and further had told the jury that they were to determine whether these commissions were in fact paid for services rendered or were a distribution of dividends to stockholders. There can be no question from an examination of the entire charge that the Trial Court submitted this case to the jury on one theory and one theory only, namely, that these commissions were either proper or improper in their entirety. This instruction, considered in relation to the entire charge and coming as it did near the end of the charge, was in effect a *peremptory* instruction. It in effect advised the jury, that if they found that a substantial portion of the sums paid as commissions were not in fact paid as compensation for services but were dividends, this would be sufficient to find the defendants guilty.

There was no evidence in the record from which the jury could find that part of the sums paid were in compensation for services rendered and part were dividends. Petitioner offered no evidence to show that the sums paid as commissions were unreasonable in relation to the service rendered. Under what conceivable theory of law could the jury be permitted to speculate, conjecture or find that part of these commissions represented dividends and part payment for services rendered on a record barren of any facts upon which to base such a finding. The criticized instruction was inconsistent with the entire theory upon which the case was submitted to the jury. As well stated by the Circuit Court of Appeals:

> "The jury was thus advised in effect that in order to convict it was only necessary that a substantial portion of the profits of Consensus were distributed to the defendants as dividends. This statement was neither consistent with the indictment nor the theory upon which the case was tried. * * * Who can say but that the jury might well have reasoned that the dis-

tributions made to the defendants were partly for services rendered and partly for profits in the form of dividends, but that the latter constituted a substantial portion and was, therefore, the guide by which they arrived at a verdict of guilty." (R. 503, 504.)

Petitioner seeks to justify this instruction on the theory that the Government is not required to prove an evasion of all the tax charged. (Brief, p. 34.) This principle of law has never been disputed. Assume A is charged with having a certain income of $20,000 and evading a tax of $3,000. It is sufficient if the proof shows he has an income of $15,000 and evaded a tax of $2,000. This principle of law, however, has no application here. Under the facts here there was no dispute as to the *amount*. The dispute related to the deduction of a certain *item*. The case was submitted to the jury on the theory that the whole case centered about the deduction of this item and that the question was whether the sums paid were paid as dividends to stockholders or compensation for services. The case was submitted to the Circuit Court of Appeals on practically the same theory. As heretofore stated there was no evidence in the record from which the the jury could find that part of the sums paid were compensation for services and part dividends to stockholders.

Petitioner further seeks for the first time to justify this charge on the theory that the instruction in question was requisite to a fair and complete charge in that its evidence presented certain problems as to the guilt or innocence of certain defendants in certain years. (Brief, p. 34.) Aside from the fact that these contentions are without record support and contrary to the theory upon which petitioner's case was submitted for the jury, these problems, if they existed, should have been covered by specific instructions as to specific defendants for specific years.

Petitioner in a further attempt to sustain this erroneous

instruction suggests that there is some question as to whether or not the exception was sufficient. (Brief, p. 34; footnote 1.) The exception was sufficient. The instruction in question was so erroneous under the facts herein and the theory upon which this case was submitted to the jury that any court of review would consider same even though no exception whatsoever was taken. *Crawford* v. *United States*, 212 U. S. 183, 194.

## III.

### THE OPINION OF THE CIRCUIT COURT OF APPEALS.

The question here presented is whether the ultimate decision of the Circuit Court of Appeals was correct. It is likewise of extreme importance to petitioner, even if that decision be correct, that the court's opinion should not contain any erroneous conclusions which might severely handicap petitioner in the future enforcement of the revenue laws. Our analysis of the facts and our discussion of the two main issues with repeated reference to the opinion indicates the thorough conscientious care of the court below in passing on these issues. Practically every question raised by either party was seriously and fully considered and disposed of in accordance with the court's best judgment.

The court having analyzed the facts, then took up the questions of law applicable to these facts and first stated:

> "The government in its brief and in oral argument before this court asserts that the deductions in question must be treated either as dividends in their entirety and if so unlawful deductions, or as commissions in their entirety and therefore properly deducted. In other words, in accordance with this argument, there can be no middle ground". (Rec. 502.)

Petitioner here for the first time questions this statement of the court and says: "We respectfully assert that the

government made no such contention; it did not rely upon any such 'all or nothing' theory." (Brief 32.)[9]

This is a plain shift from the position taken by the petitioner before the trial court and in the Circuit Court of Appeals (*supra*, p. 19). This it is not permitted to do. *Helvering* v. *Wood*, 309 U. S. 344, at 349. The purpose of this shift is obvious. Petitioner's evidence established

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9. It is significant that this statement of the court below was not questioned in petitioner's petition for rehearing. Petitioner took the same position as it had taken before the court below (Pet. for Rehearing, page 13). Petitioner's brief in the court below, stated at page 82.

"On the basis of the foregoing, it is respectfully submitted that there is no issue involved in this case regarding the question of whether commissions may be deducted or whether the payments were reasonable. We cannot repeat too often that there are no questions concerning commissions, because these payments were dividends."

As to the oral argument, a government reporter was present and the argument of petitioner was transcribed. When we directed the Solicitor General's attention to this statement appearing in his brief he promptly made available to us this transcript. We have examined same. We have suggested to the Solicitor General that the statement appearing in his brief and its argument based thereon be withdrawn or if there is any dispute between us as to the construction to be given to petitioner's argument below, that a copy of the transcript of that argument be filed as a part of the record in this case. We quote the substance of several statements from this transcript:

(Page 11.)

"Judge Major: Did I understand you to say that the item was either 'dividends' or 'commissions'?

"Mr. Hall: That is right.

"Judge Major: It might be some of each mightn't it?

"Mr. Hall: No, sir, if your Honor please. • • •

"Judge Major: Does it follow from what you said that the proof shows that no services were rendered?

"Mr. Hall: I don't say that and I say now that it does not make any difference • • •."

(Page 12.)

"Judge Major: You do not agree with what Judge Lindley says do you that the record shows that all these defendants rendered services?

"Mr. Hall: No, I do not agree with that.

"Judge Major: Mr. Hall, assuming • • • I suppose you won't agree to this but assume the record shows that the defendants rendered services to the corporation; if we assume that, would there be some kind of a presumption that at least part of the moneys they received were in payment for these services?

"Mr. Hall: None whatever."

(Pages 38, 39.)

"Judge Major: Well if you had a civil case based on exactly the same facts as you have got here • • •.

"Mr. Hall: In a civil case based on these facts the decision would have to be they were liable for taxes on all of these dividends that were charged as commissions; that none of them were deductible • • •.

"Judge Major: On all or none.

"Mr. Hall: Oh, yes, sure."

that all defendants rendered services. (Appendix I "All defendants performed services for these commissions." *Infra*, pp. 50-53.) Petitioner, however, in its brief states that little or *no* services were performed by certain of the defendants (Brief 12 and 19). Petitioner then argues throughout its brief that the jury's verdict was warranted even though some of the defendants may have rendered services (Brief 19); that the fraud was no less because some of the stockholders may have rendered services (Brief 32) and that it was not bound to prove that none of the defendants performed services (Brief 33) and follows this argument with the statement "*it was entirely proper for the jury to determine that at least part of the distributions were dividends*" (Brief 33). This is in effect an argument that the record contained evidence from which the jury could infer that part of the commissions paid were dividends and part compensation for services. This is just the contrary to petitioner's theory of the case before the trial judge and its theory and admission in the court below.

This same argument and shift of position is used by petitioner in an attempt to justify the erroneous instruction. Petitioner states: "The preceding discussion discloses also the absence of any tenable basis for the suggestion of the court below that the criticized portion of the charge to the jury was neither consistent with the indictment nor the theory upon which the case was tried (R. 503)." (Brief 33.)

This attempted shift of position by petitioner at this late date is of itself conclusive that petitioner's evidence taken as a whole was insufficient to justify the verdict of the jury based on its theory that these deductions were dividends in their entirety and that the instruction complained of was erroneous.

The court then stated that it agreed with the Government's argument that there could be no middle ground.

First, because petitioner alleged that none of the defendants "rendered any services to the company" and, second, that it was a serious question whether a prosecution for income tax evasion founded upon an improper deduction can succeed where the proof is other than that the deduction is improper in its entirety (R. 502).

Petitioner takes issue with the first conclusion of the court by claiming that its indictment did not so allege. (Brief, 15, 31, 33.) This questionable contention is made here for the first time to avoid the fact that its evidence established that all defendants rendered services. (*Supra*, p. 7, footnote 4.) Petitioner in its petition for certiorari specifically stated that Count 5 of the indictment alleges that "none of the defendants performed any services for Consensus." (Pet. page 15 footnote 9.)

Petitioner's entire criticism of the opinion of the court below is directed to its second conclusion, especially the italicized portion of the following statement:

> "*We have reached the conclusion that where a statute permits a reasonable deduction for services, a criminal prosecution cannot be maintained by proof other than that such services were not rendered.* It is not sufficient to allege or prove that a deduction claimed for services is unlawful because the amounts charged are unreasonable." (R. 502.)

Petitioner goes so far as to quote the italicized portion of this statement and then states that the judgment below was reversed upon that ground. (Brief 21) This statement is unfair in the light of the thorough examination made by the court below of the issues presented. If this had been the basis of the court's decision the case would have been reversed without remanding.

The italicized portion of this statement is clearly applicable to the facts in this case as analyzed by the court. As an abstract proposition of law standing alone, it may be too broad. It must be considered in connection with

the other language of the court. When so considered, it is obvious that all the court below held was that a criminal case could not be based only on the theory that a deduction was unreasonable. In support of its conclusion, the court relied upon the case of *U. S.* v. *Cohen Grocery Co.*, 255 U. S. 81. The decisions of this court, cited by the lower court, do raise a serious question whether a criminal action can be based on the theory only that a particular deduction for salary was unreasonable. It may well be as petitioner argues that in the light of Section 145-b of the Revenue Act and the decision of this court in the case of *Omaecherarria* v. *Idaho*, 246 U. S. 343-348, and others cited by petitioner that such a prosecution is possible (Brief, 24-30). This question may be of interest to petitioner in the future enforcement of its tax laws—and this court may well pass on this dispute between petitioner and the court below as to the correct rules of law applicable.

This question, however, is moot here in that petitioner's case was not tried in the trial court or presented to the court below on any such theory. Petitioner offered no evidence that the sums paid were unreasonable in relation to the services rendered. In so far as this case is concerned, the statement is mere dicta and was not the basis of the ultimate decision of the court.

Petitioner asserts that the gist of the offense charged under section 145(b) was the wilful attempt "in any manner to evade or defeat any tax" (Brief 22). The court below repeatedly recognized this fact and has so held in numerous opinions cited by petitioner in its brief. Petitioner also asserts that it was not required to prove evasion of the entire amount charged (Brief 22). The court below has recognized this principle several times in cases cited by petitioner. This latter principle of law has no application here, in that there was never any dispute as to

the *amount* of tax involved. This case related only to the *character* of a certain deduction, whether that deduction was proper or improper in its entirety.

Under the issues presented in this case as a basis for the claimed evasion or conspiracy to evade taxes, petitioner alleged and had to prove that the deductions of the item, commissions, in the income tax returns of the company were improper. *While the legal issue in this case was whether defendant conspired or attempted to evade the taxes of Consensus in whole or in part in any manner, the factual issue under the indictment and the record was whether or not these deductions were proper in whole or part.* Petitioner's theory was that these deductions were improper in that they constituted dividends. Petitioner's record was such in the trial court that this question was submitted to the jury on one theory only, that is, whether the deductions taken as a whole constituted dividends as such or constituted compensation for services. In an attempt to sustain the judgment of the trial court, petitioner, in the court below, admitted that these deductions were either proper or improper in their entirety, that there was no middle ground and claimed that the question of services and their reasonable value was immaterial. The court below reviewed the evidence, giving petitioner the full benefit of all inferences to which it was entitled, and correctly concluded that petitioner failed to prove that these deductions were improper. Petitioner's evidence did not even come close to proving this ultimate fact.

Using this italicized statement of the court as an abstract proposition petitioner intimates that the court in effect held that a prosecution could not be based on an unlawful deduction as long as it was *claimed* to be reasonable under Section 23(a) of the Revenue Act (Brief, 28). This intimation is particularly unfair to the court below and re-

spondents. Both in the trial court and the Circuit Court of Appeals, respondents recognized and conceded that a prosecution could be based on an unlawful deduction under this section, but claimed that the government had the burden to show, not merely that the deduction was unreasonable, but that it was so unreasonable in relation to the value of the services rendered as to constitute a fraud. (See Kruse's motion for new trial, R. 253, paragraph 8; also *supra*, p. 17, footnote 8.)

Not content with this criticism, petitioner goes even further and indicates that the court in effect held that there could be no criminal prosecution for an unlawful deduction (Brief, 28-30). The court specifically recognized that there could be (R. 502, 503). Petitioner indicates that the court's opinion in this case is contrary to its own decisions and those of other circuits holding that a criminal prosecution could be based on an unlawful deduction. (Brief 28, footnote 14.) It is sufficient here to say that in those cases the deductions in question were fictitious.[10]

Petitioner criticises the court below for stating that a fact unfavorable to the government was that this deduction was plainly disclosed in the books of the company and on its income tax returns, which were audited by the government (R. 501), and indicates that this conclusion had no factual support (page 9, footnote 5). Petitioner's contention is answered in Appendix I under the heading, "The Audits of the Income Tax Returns of Consensus by Revenue Agents", *infra*, pp. 55-57, where all the facts on this subject are set forth in detail.

Petitioner criticises the court below for failing to see the relevancy of the destruction of certain stock records and the execution and predating of certain contracts of employment (Brief 11). The only witness who testified concerning this subject was one Herbert S.

10. These cases were discussed in our answer in opposition to the petition for certiorari, pages 16 and 17.

Kamin, a lawyer, relative of Annenberg's wife, and one of the original defendants herein. As pointed out by the Circuit Court of Appeals these acts were largely the acts of Kamin (R. 501). To determine their significance as evidence in this case it is necessary to consider Kamin's testimony as a whole. See Appendix I, *infra*, pp. 40-49, particularly pp. 48-49. Petitioner's statement of these facts as they appear on pages 10 and 11 of its brief are unjustified, distorted and wholly unwarranted from the facts testified to by Kamin, its own witness.

If there was any error in the principles of law announced by the court below, it was only in its statement that it was not sufficient "to allege or prove that a deduction claimed for services is unlawful because the amount charged is unreasonable." This statement and similar statements must be considered in connection with the facts then before the court. It is pure dicta as far as this case is concerned. Petitioner never advanced such claim or offered proof on this theory.

Petitioner's entire brief is built about this one statement of the court, which standing alone, out of the context of the facts in this case, may be too broad. Seizing upon this statement petitioner argues that it was erroneous and contrary to other decisions of this court (Brief 24-30); that the entire decision of the court below was based thereon (Brief 21 and 24); that the court below set up some new standard of guilt and read an unwarranted limitation into Sec. 145(b) of the Revenue Act (Brief 28). It is perfectly apparent from our analysis of the facts, and from the court's opinion that this statement was not the basis of the court's ultimate decision—it could not be under the record. Petitioner having concluded that a criminal case may be based on an unreasonable deduction for salaries then misrepresents to the court that this is such a case (Brief 33). Petitioner first adroitly argues

throughout its brief that the fraud was no less complete because *some* of the defendants rendered services (Brief 19, 32, and 33); then petitioner misstates the record by stating that its evidence established that only certain of the defendants rendered services and the others rendered *no* services (Brief 12, and 19) and then repudiates its position before the trial court and the court below (Brief 32-33). Petitioner thus reaches its ultimate goal and states "*it was entirely proper for the jury to determine that at least part of the distributions were dividends.*" (Brief 33.) Such a shift of position is not only unfair to the court below but likewise to respondents.

The ultimate conclusion of the court below is correct. This is especially so in view of the indictment, the evidence and petitioner's shift of positions. Petitioner's criticisms of the court's opinion are wholly without justification.

## Conclusion.

The facts disclose a large deduction taken by a corporation over a period of years in the same identical manner. Petitioner in the face of a full disclosure and after the civil liability has been barred by the Statute of Limitations, in the absence of fraud, seeks to turn the facts into a criminal case. The law applicable to a deduction by a corporation for salaries or commissions paid is simply and clearly defined not only in the treasury regulations but in the decisions of the courts. In substance, it is whether or not the sums paid as compensation were reasonable in relation to the services rendered. This simple question is present in this case. Petitioner failed to prove that the payments made defendants in this case were improper on the theory that defendants had rendered no services, and offered no evidence to show that the payments made were excessive or unreasonable in relation to the services rendered. Petitioner did not even establish a civil case, much less a criminal case.

The real question involved in this appeal is whether the government in the trial established a *prima facie* case. If not, the trial judge erred in not granting defendants' motions for directed verdicts. The government had the burden of offering substantial evidence to prove that the deductions taken by Consensus for compensation paid defendants was excessive. This the government did not do. In addition thereto the trial court erroneously instructed the jury that they could find the defendants guilty if they found only that a part of these commissions were dividends. Not only was this instruction diametrically opposed to the theory on which petitioner's case was presented, but was without factual support. Faced with this situation, the Circuit Court of Appeals reversed and remanded the case.

The decision of the Circuit Court of Appeals is not based on the legal question that an income tax indictment may not be founded merely on an excessive deduction. Otherwise, the Circuit Court of Appeals would have reversed and not remanded the case. Whether that question is good law may be of interest to the court but it is moot in this case.

Defendants respectfully submit that the government in the trial of this cause did not prove civil tax liability of Consensus, let alone the guilt of defendants for attempting to evade that liability.

Respectfully submitted,

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## APPENDIX I.

## AN ANALYSIS OF THE FACTS.

### I.

### Organization, Operation and Books of Consensus.

One Sweig in 1927 at St. Louis brought into being a card known as a "rundown sheet" to be sold to bookmakers. Later he took Molasky in as a partner and on September 9, 1929, sold his interest in the business to Molasky (Govt. Ex. 63, R. 318, 319).

M. L. Annenberg at this time was the owner and head of various corporations, some of which were engaged in various phases of the racing business. The principal holding company of Annenberg's interests was the Cecelia Company. Kruse, Ragen and Molasky were employees and business associates of Annenberg in some of these ventures.

Howard Clark, called as a court's witness, on motion of petitioner, testified that in 1929 he was employed under Mr. Kruse as a bookkeeper; that the office force consisted of Kruse, Matheis, Clark and a stenographer; that approximately ten days before Consensus was organized Kruse and Molasky were in the office; that a short time later Annenberg came in; that they were talking between themselves; that he was attracted to their conversation when Annenberg called Ragen on the phone and said, "Jim, do you want to make some money?" (R. 422); that Ragen came over immediately and he, Clark, overheard part of the conversation between Annenberg, Kruse,

Molasky and Ragen, and Annenberg said that they were going to start a run-down business in St. Louis; he owned the business and was entitled to 30%; Molasky was to do the work in St. Louis and was entitled to 30%; A. W. Kruse and Ragen, Sr., were to get 20% each (R. 416).[11]

On September 18, 1929, Kruse organized an Illinois corporation known as the "Consensus Publishing Company" (Govt. Ex. 67). The three incorporators were Howard Clark, Molasky and Thomas Ryan, who, together with one Jules Taylor, subscribed for all of the stock, consisting of 100 shares, of the value of $5,000, which stock was issued as follows: Howard Clark, 20 shares; Thomas Ryan, 20 shares; William Molasky, 30 shares; Jules Taylor, 30 shares. The Clark stock was delivered to Kruse and the Molasky stock to Molasky. Nothing was paid by any of these persons for said stock.[12]

The company had no appreciable assets at its inception. It took over and expanded the original Sweig business which had not been successful. A stock book and corporate minute book were ordered; the stock issued as heretofore outlined; but no corporate meetings were held or minutes kept.

The business was operated by Molasky in St. Louis, and Kruse and Ragen, (later with the assistance of their sons), in Chicago, and as time went on greatly expanded with the result of increasing profits; Molasky collected the sums due from the sales and paid all expenses of operation other than these commissions; Molasky prepared two weekly statements, one showing the amount of collec-

11. Petitioner refers to this evidence (Brief 8, footnote 4) and disposes of same by the novel contention that "the jury by its verdict rejected this testimony."

12. On October 1, 1929, Taylor's stock was reissued to the Cecelia Investment Company (Govt. Ex. 109, R. 436); on June 3, 1933, the Molasky stock (30 shares) was reissued, 15 shares to Molasky and 15 shares to B. Hoffman, his niece. (Govt. Ex. 107 and 108, R. 367); about April 9, 1935, Clark's stock was reissued to one Herbert S. Kamin, (Govt. Ex. 201, R. 379).

tions, which he had deposited in an account in a St. Louis bank to the credit of Consensus, the other an expense statement showing the expenses which he had incurred and paid; these statements were forwarded to the Chicago office; they were taken by various bookkeepers and transcribed on work sheets to determine the amount to be distributed, that from these work sheets the entries were made into the cash book, journal and general ledger. After reimbursing Molasky for the expenses paid by him the net profits of the business, were distributed weekly by checks payable as follows: 30% to Cecelia Investment Co., 30% to Molasky, 20% to A. W. Kruse, 20% to J. M. Ragen and a weekly report, taken from these work sheets and showing the details of thes transactions, was furnished each week to the respective parties.
(For detailed description of the above, see testimony of George Matheis, R. 322 to 327.)

Shortly after the incorporation of the company in 1929, Clark, the first bookkeeper of Consensus, at Kruse's directions, opened a set of books for the company; charged the sums paid to Molasky, Ragen, and Kruse as commissions and the sums paid Cecelia as dividends (R. 411). The books opened were a cash book (Govt. Ex. CB 1-2), a journal (Govt. Ex. J-1), and a general ledger (Govt. Ex. L-1).[13]

This method of operation was followed continuously with these exceptions:

1. Subsequent to January 3, 1933, when the stock of Molasky was split, the commission checks were

13. Four bookkeepers, Clark (R. 410 to 424), Matheis (R. 321 to 339), Burris (R. 339 to 345), and Sandberg (R. 357 to 362), who worked on these books at various times from 1929 to 1940, testified in detail that they were kept under Kruse's supervision; that all receipts and disbursements of the company were duly and correctly entered therein; that the procedure heretofore outlined was uniformly followed from 1929 to 1940; that these books truly and correctly reflected every transaction of the company and that they were in no way altered or changed and were in the same condition as when they worked on them; that they were from time to time made available to government revenue agents; that the income tax returns of the company were made up from them and disclosed on their face every transaction reflected in the books.

made payable on a basis of 15% to B. F. Hoffman and 15% to Molasky.

2. On or about April 3, 1931, Ragen brought his son, James M. Ragen, Jr., into the business and the commission checks from that date were made payable to J. M. Ragen, Jr.

3. On or about August 5, 1932, Kruse brought his son, Lester Kruse, into the business and from that date the commission checks were made payable to Lester until January 6, 1937, when they were again made payable to Kruse.

## II.

### The Work Sheets and Weekly Reports of Consensus.

Petitioner refers to the fact that certain of these work sheets and weekly reports labeled the distributions to Kruse, *et al.*, as "dividends" as being evidence to support the jury's finding (Brief 19), and claims this fact is cogent evidence that the payments so made "were in fact dividends or distribution of profits and not commissions" (Brief 9).

Petitioner concedes that the bookkeeper who received the weekly statements from Molasky "constructed his own work sheets on which he computed the receipts, expenses, net profits and distribution of the profits" (R. 414), and that reports showing this information were sent to the recipients of the net profits each week (Brief, 8). The weekly reports so furnished were copied by a stenographer from the work sheets and were an exact copy of the work sheets (R. 337).

Clark, the first bookkeeper, testified that he prepared these work sheets of his own volition for his own use; that on those sheets he showed the moneys paid to Ragen, Kruse and Molasky as commissions and the moneys paid Cecelia as "dividends" under a separate heading entitled "dis-

bursements" and lumped them together as dividends; **that his failure to add the word "commissions" to the work sheets was pure neglect on his part (R. 418).**

Matheis, who succeeded Clark in 1933, testified that he continued this practice on the work sheet which Clark had used; that when he (Matheis) started a new work sheet in August, 1933, he showed under the heading "disbursements" the amounts paid Kruse, *et al.*, as "commissions" and the amount paid Cecelia as "dividends" to conform to the books as Clark had gone wrong on the work sheets; that nobody told him to make this correction (R. 337).

Sandberg, the bookkeeper of Consensus from September, 1936, when his attention was directed to the fact that certain of his work sheets and necessarily the weekly reports showed the sums paid to Kruse, *et al.*, as dividends (From June 5, 1937, through November 5, 1937) stated:

> "The item showed on the work sheet is dividends and commissions; in some places it does not say commissions. That is an **error**, possibly an oversight in writing up the work sheets." (R. 361.)

Petitioner nowhere in its brief mentions that the bookkeepers who were responsible for the lumping of the two items together under one heading "dividends" all testified that this was the result of error or neglect on the part of themselves and nothing else.

## III.

**Herbert S. Kamin; His Status, Duties and Activities; the Destruction of the Original Stock Book and Certificates; The Issuance of All the Stock of Cecelia; the Preparation and Predating of the Corporate Minutes; the Preparation and Predating of the Employment Contracts; and Execution of the Income Tax Returns of Consensus.**

*Introduction.*

Making no reference to Herbert S. Kamin and his activities in this connection, petitioner refers to these facts as evidence of an attempt or conspiracy to defeat and evade the taxes of Consensus (Brief 19).

Kamin was an attorney, a relative of Annenberg's wife and in 1933 came to Chicago to take charge of the various corporate records of about 75 of the Annenberg companies, including Consensus (R. 386), and continued to have charge of these records up to the time of the trial (R. 371). Kamin, together with Annenberg and Jules Taylor, was one of the original defendants in this case. These defendants were dismissed on July 22, 1940.[14]

Petitioner, having made much of the destruction of

14. As fully appears from the record herein as a result of an extended investigation into the affairs of M. L. Annenberg, his companies, his relatives (including his son, Walter) and his business associates, the June and July 1939 federal grand juries at Chicago returned many inter-related indictments (mostly income tax), including this one (Consensus), against Annenberg, his son, Walter, certain of his relatives, business associates and certain of the defendants herein. The principal indictment, No. 31762, charged an attempt and conspiracy to evade the income taxes of Cecelia. As a result of negotiations between counsel arrangements were made for Annenberg and one Joseph E. Hafner, the bookkeeper of Cecelia, to plead guilty to Count Five of indictment No. 31762, the consideration of which was to be the dismissal of many of the indictments returned and many of the defendants from other indictments. This "arrangement" was reduced to writing in the form of a stipulation (R. 226), which was suppressed until petitioner was ordered to produce same and it was impounded as a part of the record in this case (R. 225). Upon Annenberg and Hafner being sentenced on the Fifth Count of Case No. 31762, the government on July 22, 1940, performed its part of the "arrangement." This included the dismissal of Kamin, Annenberg and Tayler from the indictment in question (R. 227).

certain records and the predating of others, we propose to analyze Kamin's testimony in detail (he being the only witness who testified on this subject) and where references are made to the record, they refer to Kamin's testimony. This analysis will show an entirely different picture than petitioner's version of these facts on pages 10 and 11 in its brief. According to petitioner's version Kruse *instructed* an *employee* to do all these acts because he, Kruse, was concerned over a certain opinion of the Board of Tax Appeals to the effect that if payments were made to stockholders in the same proportions as their stock holdings these payments constituted dividends.[15] The *employee* was Kamin. In many instances Kamin testified as to what Kruse told him, and that certain actions were taken after conversations with Kruse. The testimony as to what Kruse told him, unless contradicted and there is no contradiction in this case, is evidence of that fact and binding on petitioner.[16]

*Kamin's Status, Duties and Activities.*

Kamin worked for the Annenberg companies. He worked for them, including Annenberg. Mr. Annenberg owned them. He didn't work for Kruse. He worked under Kruse, who was his superior (R. 387). **Kamin testified that when he said Kruse was his superior he would not have done anything unlawful because Kruse asked him to if Kruse did; that Kruse could tell him regarding certain duties but he couldn't tell him as a lawyer regarding the law and he didn't take those orders; that if he believed anything was illegal he would not take orders from Kruse or anybody else (R. 393)**; that when he took charge of

15. We have been unable to find such an opinion in any of the reported decisions of the Board or of any Court. Petitioner cites none.

16. In the recent case of *U. S.* v. *Young*, 97 Fed. (2d) 200, 117 A. L. R. 316, the court held that the government was bound by exculpatory statements shown in its evidence unless contradicted. This question is fully covered in the A. L. R. note.

the various corporate record books of the Annenberg companies, including Consensus, he found that no corporate minutes had been kept, that the stock of most of them were held in the name of dummies and the whole thing was pretty much of a mess; that it was his duty to straighten out these records, bring their minutes up to date and get the stock of these corporations held in the name of dummies into the one big Annenberg Company, Cecelia (R. 371); that it was his duty to see that all these little corporations, whatever they were, had their minutes prepared and brought up to date and where stock was in the name of dummies arrangements were made so that the stock would reach Cecelia (R. 385, 386).

Kamin's actions in connection with Consensus were no different from his actions in connection with the books and records of other Annenberg companies. Prior to the time he took charge of the Consensus books he had straightened out other Annenberg corporations where he had procured stock certificates outstanding in the names of dummies, issued them to Cecelia and had written up minutes (R. 386). He drew new stock certificates and dated them back in other corporations and tore the old ones up. He predated minutes of maybe fifty of these corporations (R. 396, 397). The entire object and purpose of his acts in relation to Consensus are reflected in his testimony:

> **"The purpose of those stock certificates and my work in connection with the Consensus Publishing Company was to show ownership of all of the stock in Cecelia Company. I found that the stock of the Consensus Publishing Company had been issued in the names of various dummies, that Mr. Kruse had possession of one of those certificates, Mr. Molasky of one, and Mr. Ragen of one. I was to get those stock certificates." (R. 387.)**

Kamin did not start work on the books and records of Consensus until the summer of 1934 (R. 390). Kamin's testimony on the destruction preparation and predating of these documents follows:

1. THE STOCK OWNERSHIP OF CONSENSUS, THE ISSUANCE OF NEW STOCK, AND THE DESTRUCTION OF THE OLD STOCK BOOK.

In the summer of 1934, Kamin first discussed with Kruse the situation as to Consensus. In referring to its stock, Kruse told him that a meeting was held at which Annenberg, Molasky, Ragen and Kruse were present and there was an agreement that Cecelia was to own its entire stock; that there was an oral agreement made that Molasky was to get 30% of the profits, Ragen 20% and Kruse 20% as commissions for services rendered and to be rendered (R. 392); that the reason Cecelia took over that business was because Molasky was losing money and Ragen, as head of the General News Service, and Kruse as head of the Racing Form could get business from their customers (R. 392). Kruse advised him that Cecelia should have owned all the stock of Consensus from the beginning; that the stock was issued incorrectly and that there had been some transfers of that stock and therefore the persons who held the stock were not the real owners; that Cecelia owned all the stock and therefore he wanted the stock book to reflect the true ownership (R. 374, 375). Kamin suggested to Kruse that in making the stock book reflect Cecelia's ownership, the outstanding shares should be transferred in the stock book but Kruse was of the opinion that it would raise a lot of unnecessary questions and that in view of the fact that there were no interests of third parties involved that he, Kruse, did not see why they should not make a new book and reflect the ownership correctly from the beginning; Kruse said that these people were drawing commissions from the company since its inception in the percentages of 20, 20 and 30; that they were paid as commissions and they had agreed to pay them as commissions from the beginning and the fact that the stock was issued in those proportions might tend to show that they were not commissions and therefore the stock

should be issued correctly to show Cecelia as the owner of all the stock (R. 375, 376). Kamin advised Kruse that he thought it was an irregular procedure to destroy an old book instead of making the transfers in the old book but Kruse wanted it done that way and Kamin did not see anything particularly wrong in it (R. 379). Kamin testified:

> "My purpose in destroying the first stock certificate book was because in my opinion it had no further validity. The new stock having been issued, the Cecelia Company would have it, and it should be destroyed." (R. 388.)

In connection with the destruction of the stock book, Kamin did not have in mind or discuss any questions relating to income tax of the United States (R. 388).

Kamin, on or about August 27, 1934, prepared five new stock certificates of the corporation from blanks in his desk and predated them to September 18, 1929. The first four were made out in the names of the original subscribers for the amount of shares originally subscribed by them, and the fifth certificate, No. 5, to The Cecelia Company for 100 shares. These were sent to Molasky at St. Louis on August 27, 1934, accompanied by the following letter (Govt. Ex. 200, R. 377):

> "DEAR BILL:
>
> "Kindly sign the enclosed stock Certificates on the Consensus Publishing Company as president and also endorse your own certificate on the assignment on the back thereof.
>
> "Please mail these certificates back to me immediately.
>
> "Very truly yours,
>
> HERBERT KAMIN."

These certificates were signed by Molasky, the one issued to him endorsed, and returned; Clark endorsed his and it was cancelled, together with those issued to Taylor,

Molasky and Ryan. The original thirty share certificate issued to Cecelia was turned back. The new certificate #5, issued to Cecelia for 100 shares of stock of the Consensus Company (the entire stock) was then delivered to Annenberg, who put it in the Cecelia vaults at the First National Bank where it has since remained; all of which took place on or about August 27, 1934 (R. 377, 378). The old stock book remained in existence for about a year when it was destroyed (R. 380).

At the time of the original conversation with Kruse, Kamin told Kruse that the outstanding original certificates of stock should be called in and cancelled and in view of the fact that they were going to destroy the stock book, these certificates would be cancelled by destruction. Kruse was perfectly agreeable to surrender his, but it turned out later that Molasky refused to return his stock certificates and no one returned theirs because Kamin felt it was unfair for the others to turn theirs in. Kamin asked Molasky to turn his in several times, and Molasky said that he wanted to have something that would guarantee him more than just a year's employment contract; that he (Molasky) wanted something tangible to show, in the event of his death, that he would be entitled to something from the company (R. 378, 379). These original stock certificates remained outstanding until 1938. In 1938 a ten-year employment contract was made with Molasky, Kruse and Ragen, Jr., all guaranteed by Cecelia. At that time these outstanding certificates were destroyed (R. 384).[17]

17. For the details of this destruction see petitioner's brief (page 11, footnote 7). The ludicrous sequel of these acts was that it availed them nothing. Molasky before he surrendered his certificate and that of R. Hoffman to Kamin in 1938 had them photostated (R. 366). He and his attorney later turned them over to the government prosecutor (R. 435) who used them against Molasky and the other defendants in this case (Govt. Exs. 107, 108).

### 2. THE WRITING UP AND PREDATING OF THE CORPORATE MINUTES.

When Kamin took charge of the Consensus corporate minute book (Govt. Ex. 59) it was no different from the minute books of many other of the Annenberg companies in that no record of any meetings appeared therein (R. 386). The Consensus minute book was never destroyed, doctored, altered or changed in any particular from the condition it was in when Kamin first saw it other than the minutes written up by him (R. 396). Subsequent to his first conversation with Kruse and about the time the new stock certificates were issued, Kamin prepared the minutes for the meetings from January 2, 1930, up to 1934, predated them, had them signed and from that time on kept the minutes of the corporation up to date (R. 384, 393).

### 3. THE PREPARATION OF THE EMPLOYMENT CONTRACTS.

Kruse talked to Kamin about drawing written employment contracts at or about the time the new stock was made (or it may have been later), advising him that the defendants had oral contracts with the company in which they were paid commissions; that, being oral, they might be hard to prove and, therefore, he thought they should have written contracts covering the entire period. So, they were drawn up (R. 381). Kamin did not recall whether he drew them up in 1934, 1935 or 1936.[18] They were predated and provided for the payment to Kruse, his son, Ragen, his son, and Molasky of a percentage of the profits equivalent to the commissions paid them, and from then on yearly contracts were prepared (R. 381). Kamin stated:

> **"The employment contracts were prepared, written and dictated by me. I always knew of my own knowl-**

18. Katherin Keeler, a handwriting and typewriting expert, expressed opinions from which it could be inferred that certain of these contracts were first signed in 1936.

edge that Molasky, Kruse and Ragen were connected with the company and did work for the company" (R. 388).

These employment contracts were all introduced in evidence as Government Exhibits 75 to 97, inclusive.

#### 4. THE SIGNING OF THE INCOME TAX RETURNS.

Kamin testified that in 1934 he had some discussion with Kruse about a case before the Board of Tax Appeals where commissions were given to a man that owned all the stock of the corporation, in which case the Board of Tax Appeals had held that where stockholders received a division of the profits in proportion to their stock holdings these payments were not a deductible expense (R. 393); that Kruse then told Kamin that he wanted what actually occurred reflected in a proper and legal manner (R. 393).

Kamin signed the income tax return of the company for the year 1935 (Govt. Ex. 7) as treasurer, and its 1936 return (Govt. Ex. 8) as secretary of the company, with full knowledge of the opinion of the Board of Tax Appeals, with full knowledge of the fact that certain of the original certificates of Consensus were outstanding and with full knowledge that these commissions had been paid to Ragen, Kruse and Molasky, and were taken as a deduction. When asked for an explanation of why he did so he stated that neither Ragen, Kruse, or Molasky were stockholders, that Cecelia owned all the stock of Consensus (R. 397).

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Kamin's testimony taken as a whole is conclusive that from the inception of Consensus it was the intention of all parties that M. L. Annenberg through Cecelia was to be the owner of Consensus; that Kruse, Ragen and Molasky were to receive a percentage of the profits for services rendered and to be rendered; that up to 1934 the stock of practically all of Annenberg's companies, including

Consensus, was held by dummies; that in 1934 all of the stock of Consensus was reissued in the name of Cecelia as of September 18, 1929, and delivered to Annenberg where it has since remained; that at this time the persons who held this stock were requested to surrender the original stock certificates of Consensus held by them; that Kruse was at all times willing to do so; that Molasky procrastinated and did not do so until 1938, when he, Kruse and Ragen received ten-year employment contracts from Consensus guaranteed by Cecelia; that in 1938 the original stock certificates were destroyed; that no minutes of Consensus were kept from 1930 to 1934; that in 1934 Kamin wrote up all the minutes of Consensus to 1934 and from that time kept the minute book up to date, in no way tampering with them; that the employment contracts were prepared some time in 1934, 1935, or 1936, to cover the prior period and were all predated and signed at one time and employment contracts from year to year were executed thereafter.

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Petitioner in support of its argument that the evidence was sufficient to go to the jury states:

> "Defendants participated in the destruction of critical documents and in the execution of spurious predated contracts of employment." (Brief, 20.)

The destruction of certain of these documents and the execution and predating of others must necessarily be considered in connection with Kamin's entire testimony. His primary purpose in connection with Consensus as disclosed by his testimony was to get its records in shape to reflect the true condition of the company from its inception, to get the minutes brought up to date and get its stock then held by dummies into Cecelia, the main Annenberg company. That this was his purpose is corroborated by his own testimony that he had the same problem in respect to a number of other Annenberg companies and

did substantially the same thing. The predating of the corporate minutes and the execution of the employment contracts were but to reflect a condition which existed prior thereto. There is nothing in petitioner's evidence to show that the condition existed other than as testified to by Clark and other than as told by Kruse to both Kamin and Burris. Considering petitioner's evidence as a whole, we are of the opinion that its reference to the employment contracts as *spurious* is unjustified.

As to the destruction of the stock record, Kamin himself testified that while he thought it was irregular, he saw nothing particularly wrong with it (R. 379) and further testified that his purpose in destroying the stock record was because in his opinion it had no further validity, the stock having been issued, Cecelia would have it and it should be destroyed (R. 388). As to the destruction of the stock certificates and the method, it was the obvious intention of the parties that they should be *destroyed*. Kamin suggested it. (R. 378.)

Petitioner makes much of the destruction of these records. Just what probative value this evidence has in this case is doubtful. At the most, this may constitute a circumstance establishing that the defendants were stockholders to be considered with the other proof in this case with that caution and circumspection which its inconclusiveness standing alone requires. *Hickory* v. *U. S.*, 160 U. S. 408, 410. It is not proof of the fact that the defendants were stockholders; it certainly is not proof of the fact that there was an attempt and conspiracy to evade the taxes of Consensus.

## IV.

**All Defendants Performed Services for These Commissions.**

Petitioner at last concedes that Molasky and Kruse, Sr. rendered services to Consensus (Brief 12) so this fact is no longer open to dispute.

Petitioner states, "But there is also evidence that little or no services were performed by the other respondents" (Brief 12), referring to Ragen, Ragen, Jr., and Lester Kruse. In support of this statement, petitioner refers to certain testimony of one Burris and one Brooks. Petitioner states that Burris testified that he had no knowledge of any work that Lester Kruse, Ragen, Sr. or Ragen, Jr. ever did for Consensus. Burris stated on cross-examination that he had no occasion to know what work they did (R. 344).

Petitioner refers to the fact that Brooks did not know these defendants (Brief 12). Brooks was an employee of Molasky in St. Louis and had supervision of the printing and distribution of the rundown sheets from St. Louis. He testified that most of his dealings with Consensus were by telephone and he talked to the various defendants in Chicago many times; that when he said he talked to Ragen, he meant Ragen and Ragen, Jr.; that when he said he talked to Kruse, he meant Kruse and Kruse's son; that if Ragen wasn't in, he would talk to Kruse; that if Kruse wasn't in, he would talk to Lester (R. 355). This evidence of Burris and Brooks is far from establishing that no services were rendered by Ragen, Sr., Ragen, Jr. and Lester.

In a further attempt to reflect upon the services rendered by all defendants, petitioner refers to Brooks as **an employee of another company owned by Molasky** and states:

> "In answer to repeated questions by the court at the trial Brooks testified that there wasn't much supervis-

> ing that had to be done but that he did all of it and no one else did any," (Brief 6)

a clear inference that Brooks ran the business and the defendants did practically nothing. Brooks on cross-examination testified:

> "When I stated that I did practically all the supervising work I meant with reference to the printing of the sheets only. **The conduct of the rest of the business was all done by Molasky**" (R. 354).

Brooks was testifying as to the activities in St. Louis, which were handled by Molasky. This testimony here had no reference to the activities of the other defendants in Chicago. Brooks also testified as to some of the services of Molasky (R. 354).

The fact, that petitioner intended to use the quoted portion of Brooks' testimony as a basis for its ultimate conclusion that there was ample evidence to justify the jury's verdict, is reflected on page 19 of its brief. In arguing that the verdict of the jury was amply supported by the record, petitioner states (Brief 19):

> "The fact that the essential operations of the company were simple and were carried on largely by **part-time employees** * * *—all these furnish overwhelming support for the jury's conclusion * * *."

What petitioner intends to convey to this court is that Brooks actually ran Consensus just as they so stated to the Circuit Court of Appeals in these words, "**Gordon Brooks, who actually ran the business.**"[19]

The record shows that Ragen, Sr., Ragen, Jr., and Lester

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19. The following are some of the quotations from petitioner's brief filed in the Circuit Court of Appeals:

1. "Gordon Brooks, an employee of one of Molasky's companies in St. Louis was in charge of the business; it required very little supervision, perhaps an hour or two of work a day (R. 351, 352)." (Brief 12.)
2. "Brooks testified that he supervised all of the work in the company's business as Molasky's representative (R. 351, 352). (Brief 47.)
3. "Brooks testified that there was not much supervision that had to be done but he did all of it and that no one else did any (R. 352)." (Brief 47.)
4. **"Gordon Brooks, who actually ran the business."** (Brief 77.)

Kruse also performed services for the company and all defendants were paid these commissions for such services (R. 322, 351, 354, 355, 359, 387, 388, 392). Both the trial court and the Circuit Court of Appeals after reviewing the evidence, concluded that it disclosed that all defendants had in fact performed services for Consensus and were entitled to compensation therefor.[20] **No compensation was paid to any of these defendants for such services other than these commissions.**

Petitioner throughout its brief assumes that its evidence established that some of the defendants (Kruse and Molasky) only performed services, and the others rendered no services. We have heretofore shown that its claim that the other defendants rendered no services was based on a misconstruction of the testimony of Brook and Burris. On page 19 of its brief, petitioner states, "The verdict was fully warranted even though some of the defendants may have rendered some services." Later on the same page in detailing certain facts claimed to support the verdict of the jury, petitioner states, "The fact that at least some of the defendants rendered no services at all, or at best, only fragmentary services." This is a clear misstatement of petitioner's evidence. Its evidence established that all defendants performed services. Its evidence is not that certain defendants rendered *fragmentary* services, but its evidence is *fragmentary* as to the

20. The trial court said:

"In other words, once having shown,—and this evidence does show,—that they rendered,—some of them at least, and perhaps all of them, perhaps all of them,—that they rendered some services: Now having shown they received some services and that they received these things as commissions, haven't you got to go further and show, in order to create a fraudulent intent that these commissions received were all out of proportion to the services rendered?" (R. 463.)

The U. S. Circuit Court of Appeals said:

"We think there is considerable testimony in the record of services rendered by Molasky, who was president of Consensus, as well as by Kruse, Sr., and some evidence of services performed by the other defendants." (R. 500.)

"The proof shows without doubt that they rendered services to Consensus and were entitled to compensation in the form of salary or otherwise." (R. 503.)

extent of the services rendered by all of the defendants. Petitioner's evidence established that all defendants rendered services and were paid these commissions for such services.

The Circuit Court of Appeals stated:

> "It does not require a great deal of proof to be convincing that the executives, managers, and employees of a corporation which earned a gross income of $119,960.96 for the year 1933 (in some years the income was much greater) rendered services and were reasonably entitled to substantial salaries. In 1929, Consensus took over a business—if it can be thus dignified—that was a losing proposition, and made it a financial success. So far as is disclosed by this record, these defendants alone were responsible for that success. According to the Government's theory, no executive ability was displayed and no service rendered for which the defendants were entitled to compensation or salary. Such a theory is incredible." (R. 500.)

## V.

### The Amount of Taxes Claimed To Be Evaded.

James W. Hyland, an agent for the Bureau of Internal Revenue, testified concerning various analyses made by him of the documents in evidence to show that Consensus owed the government additional taxes for the years in question.

The figures given by him as to gross income and expenses were identical to those in the Consensus books, the income tax returns and the indictment. By way of hypothetical question, including all figures on the books and in the income tax returns but completely ignoring the commissions paid as a deduction, he detailed over the objection of defendants his conclusions that the company owed the government additional taxes in the exact amounts claimed in the indictment. In other words, completely eliminating these commissions as an expense deduction and allowing

defendant corporation nothing as a deduction for the sums paid Molasky, Ragen, Ragen, Jr., Kruse, and Kruse, Jr., as commission, for services, Hayland arrived at the figures in the indictment, as to the amount of taxes alleged to be due. He testified:

> **"In arriving at the tax due from this company I assumed that Ragen and his son, Molasky, Kruse and his son were not entitled to one penny of commissions"** (R. 429).

Hyland further testified that he examined the bank accounts and the personal checks of the various defendants (other than those of the Ragens) to determine what disposition was made of the sums received by them as commissions (R. 439). A summary of his testimony follows:

1. The proceeds of the checks to Molasky and B. Hoffman were used by Molasky.

2. The proceeds of the checks to Kruse, Ragen and Ragen, Jr., were used by these respective parties.

3. The checks issued to Lester Kruse were deposited either in a savings account entitled "A. W. Kruse Special" 973655 for the benefit of Lester against which account A. W. Kruse had a right to draw funds or in Lester Kruse's account at the First National Bank, against which both he and his father could draw checks.[21]

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21. Petitioner infers that Kruse withdrew Lester's funds for his own benefit (Brief 7 footnote). The record indicates that insofar as the special savings account #973655 is concerned it was intact at the time of the trial, no part having been withdrawn. As to the other account, Kruse had authority to draw on this account and did draw on same but there is no evidence that any of these moneys were used for Kruse's own benefit. The record indicates that the moneys received by Lester were at all times segregated from those of Kruse. Burris testified that at Kruse's direction he segregated the moneys payable to Lester as against Kruse's funds, that he kept a personal cash book for both Kruse and Lester (R. 341).

At the time of the Annenberg investigation Kruse voluntarily delivered to Petitioner all the personal checks of Lester and himself (R. 365). Petitioner offered no proof that any of Lester's funds were used by Kruse for his own benefit.

## VI.

### The Audits of the Income Tax Returns of Consensus by Revenue Agents.

Each of the income tax returns of Consensus showed on their face the deduction of these commissions as an expense —the fact that 70% of the profits of Consensus were taken as a deduction.[22]

Corporate returns are checked for apparent errors on the face when originally filed, then sent to the Commissioner at Washington; a preliminary audit is then made, and in certain instances the Commissioner determines to go back of the figures and make an audit of the return which is accomplished by returning it to the agent in Chicago who makes a field audit (R. 317); that the income tax returns of Consensus for the years 1931 and 1932 were so audited and additional taxes in small amounts assessed (these additional assessments related to matters other than the commissions) (R. 316). The returns on their face show these audits.

Mr. Hyland, of the Chicago Revenue Office, testified that an audit involved a detailed examination of the books and records of a company by the field agents; that the purpose of an audit was to ascertain whether the amount reported on the tax return was properly reflected on the corporate records and whether the deductions therefrom are proper and in accordance with the revenue law; that they take each item of deductions as shown in the return, see that it is properly reflected by the records and then

22. Burris testified he had examined several hundred income tax returns; that he had never before seen a deduction as a business expense, of this character and magnitude; that when he noticed it in this case he immediately asked Kruse as to the reason of this kind of a deduction (R. 343). The government objected to both Burris (R. 344) and Hyland (R. 439) testifying that the most casual examination of these income tax returns of Consensus by anyone having experience in income tax returns would call for inquiry under what circumstances these commissions were paid.

ascertain whether it is a proper deduction under the Revenue Act (R. 437); that in 1936 he Hyland made such an audit of Consensus for the years 1933 and 1934. Hyland detailed exactly what he did (R. 425).

Government Revenue Agents were continuously from at least 1933 up to 1939 in the office of Cecelia examining either its books or the books of other Annenberg companies. As far as Consensus was concerned they were given any records or information desired by them (R. 318, 338, 361, 362, 398, 424, 437).

Petitioner on page 9 of its brief (Footnote 5) states:

> "The court below apparently attached some significance to the fact that the tax returns disclosed the deductions in question (R. 501). * * * Again, the opinion states as a fact that the returns had been audited, implying that the Government had knowledge of the facts. This receives no support in the record, * * *. Further, such an examination, even if made, would not be binding on the Government."

If petitioner intends to imply that the record does not support the fact that audits were made, we refer this court to the testimony heretofore discussed. As to the government's knowledge, we say that the income tax returns were of such a nature that by the exercise of the most casual observation or care petitioner was put on inquiry; that petitioner at all times had knowledge of these deductions is reflected from the character of the income tax returns; the audits made; and the method of handling income tax returns.

We concede that these audits would not be binding on the government. That is not the question. The fact is that the government from practically 1929 on had full knowledge, or by the exercise of the most ordinary care, could have acquired knowledge of the facts and circumstances under which these commissions were paid and the deductions were taken. Is it any wonder that the court below under these circumstances attached some significance

favorable to defendant from the fact that the tax returns disclosed there deductions; that they were audited from time to time by revenue agents; that no objection was made to the deductions in question; and that Revenue Agents at least from 1933 on had full access to the books and records of Consensus and were given such information as they desired?

## VII.

**Defendants Not Only Received All These Commissions for Their Own Benefit But Paid Income Taxes on Same.**

All of the defendants reported in their individual income tax returns, received in evidence, the sums paid them as commissions, treated them as a payment for services rendered and paid both normal and surtax on same with the exception of Molasky and B. Hoffman who in their 1933, 1934 and 1935 returns reported them as "dividends." Molasky prior to 1933 had also returned these sums as compensation for services and paid full taxes thereon. The government in the spring of 1936 audited the income tax return of B. Hoffman for the year 1934 (Govt. Ex. 57) and assessed an additional tax of $458.78 against her in effect recognizing that the payments she received from Consensus were not in fact dividends but commissions and salaries and subject to the normal tax. A copy of the audit made is attached to the income tax return.[23] Subsequent thereto Molasky and B. Hoffman likewise reported the amounts paid them from Consensus as salaries or commissions and not dividends, and paid taxes thereon.

23. Upon B. Hoffman procuring a letter from Consensus, attached to the audit, to the effect that these were commissions, the Government was content to rest there. It meant more taxes.

## APPENDIX II.

### Petitioner's Evidence Was Insufficient To Justify a Finding That Defendants Were Stockholders of Consensus.

Petitioner regards this case as the ordinary one where a jury's verdict is conclusive as to disputed questions of fact between the testimony of Government and defenses witnesses. This is illustrated by its statement in reference to Clark's testimony, "In any event the jury by its verdict rejected this testimony." (Brief 8, Footnote 4.) The problem presented is not so simple, and the above rule of law has no application here.

The only evidence offered in this case was that of petitioner's witnesses. Having called these witnesses, it was bound by their testimony in the absence of contradiction or mistake. *Cartello* v. *U. S.*, 93 Fed. (2d) 412, C. C. A. 8. The facts as such are not seriously in dispute. There are, however, many inconsistent facts in petitioner's own evidence and numerous conflicting hypotheses and inferences which can be drawn from these facts. Petitioner concedes this fact but erroneously asserts that the jury resolved these inferences in petitioner's favor (Brief 18).[24]

To illustrate, considering petitioner's evidence as a whole, there are certain facts from which it may be inferred that the defendants were stockholders; there are other facts from which it may be inferred that they were not stockholders. These were conflicting hypotheses or inferences which petitioner was bound to reconcile before it was

24. "This was a simple issue of fact, resolved by the jury's verdict. The majority opinion of Circuit Judge Major, however, contains an elaborate narration of the evidence (R. 497-502). *It undertakes to cast a balance between the conflicting inferences, approving some of the Government's contentions* (R. 499), *and more of the respondents* (R. 500-502)."

Note petitioner's claim of the effect of the jury verdict.

entitled to have its case submitted to a jury. Evidence which is consistent with two conflicting hypothese tends to prove neither. *Gunning* v. *Cooley*, 281 U. S. 90, 94. Proof of circumstances which while consistent with guilt are not inconsistent with innocence, will not support a conviction. *Cox* v. *U. S.*, 96 Fed. (2d) 41, 43 (C. C. A. 8). In addition thereto the circumstances *proved must be consistent with each other*, consistent with the hypothesis that the accused is guilty and at the same time inconsistent with the hypothesis that he is innocent. *Reviera* v. *U. S.*, 57 Fed. (2d) 816, 822, C. C. A. 1.[25] The jury's verdict in this case adds nothing to petitioner's case on appeal. It is of the utmost importance that these principles of law be kept in mind in considering the sufficiency of petitioner's evidence to establish that any of these defendants were stockholders.

We do not contend that there is no evidence in this record from which a jury might infer that some of the defendants at some time were stockholders of Consensus. Petitioner in its brief has directed this court's attention to these facts.

These facts and the hypothesis of ownership, which may arise therefrom, must, however, be considered in connection with the other evidence in this case on the same subject. We refer this court to the testimony of Clark as to the original agreement, Appendix I, *supra*, p. 35; the fact that defendants paid nothing for this stock Kruse's representation to both Kamin and Burris concerning that arrangement; the clear distinction in the corporate books from their

25. The simplest case on this subject which we have been able to find is *Jackson* v. *State*, 12 Okla. Crim. 446, 158 Pac. 292. A was indicted for selling whiskey. The State used two witnesses, one of whom testified A sold him the whiskey; the other witness testified that they did not buy the whiskey from A but from B. A did not testify. His motion for a directed verdict was overruled, and the jury returned a verdict of guilty. On appeal the case was reversed. The court stated:

"The State cannot put on two witnesses and prove by one of them that there is a probability of defendant's guilt and another that he is innocent absolutely, and expect this court to uphold the judgment."

The conflict that existed was in the State's own evidence.

Had the State put on one witness who testified that he purchased the whiskey from A and had A testified and denied the sale, the jury's verdict would have been conclusive against A.

inception of the sums paid Cecelia and the sums paid the others; and the general broad situation of all the Annenberg companies as described by Kamin, namely, that the stock of all of these companies, including Consensus, was held in the name of dummies. At this time, 1934, the corporate records were brought up to date, a new stock book and certificates issued with the ultimate effect that a new certificate for 100 shares of stock was issued by the company in favor of Cecelia, delivered to Annenberg and placed in the vaults of Ceceila. Every corporate record from then on was consistent only with the theory that Cecelia was the owner of Consensus. The only inconsistent fact was Molasky's procrastination about the surrender of his original certificate and possibly the circumstances under which they were destroyed in 1938. Kruse had been perfectly willing to surrender his in 1934. For details see analysis of Kamin's testimony, Appendix I, *supra*, pp. 40-49.

It is not so much a question of the possession of this stock but rather a question of the intention of the parties. Were the defendants who held possession of these stock certificates the bona fide holders thereof with full power to use that stock as they saw fit, including the power to dispose of it to strangers? A fair inference is that they could not have done so. What stranger would have purchased this stock without first obtaining the consent of Annenberg? Petitioner's evidence, with its many conflicts, as to whether defendants held this stock as owners or dummies for Annenberg, was insufficient to present to the jury the question whether or not Kruse, Ragen and Molasky were in fact stockholders of Consensus.[26]

It is difficult to understand how petitioner in this case

26. The Circuit Court of Appeals concluded:

"In our judgment the record justifies the conclusion that they (Ragen, Kruse and Molasky) were such owners." (Rec. 499—parentheses ours.)

We do not agree with this conclusion. The Court of Appeals may well have been proceeding on the theory that petitioner was only required to establish that the record contained some evidence that defendants were stockholders.

can conscientiously urge that these defendants were stockholders. It must be assumed that petitioner in the light of the extensive investigation of the affairs of M. L. Annenberg (as fully disclosed from the record herein) was fully aware as to the actual facts of the entire Annenberg picture at the time of the return of this mass of indictments. The contents of these various inter-related indictments was a matter of judicial notice before the trial court. Petitioner in the Cecelia indictment No. 31762 in effect charged that Annenberg through Cecelia was the owner of Consensus from 1929 on.[27] The basic theory behind the indictment in the case at bar was that certain of these commissions were in fact dividends. But the theory was not that they were a distribution of dividends to these defendants but to the defendant M. L. Annenberg in that these defendants were turning back to him certain of the moneys which they received.[28] Petitioner was unable to substantiate this theory. (*Supra*, p. 57.)

27. "That said Cecelia Company owned all or large controlling amounts of the capital stock of the next hereinafter mentioned corporations, and the said Moses L. Annenberg, by virtue of his ownership of Cecelia Company as aforesaid, and also by virtue of direct and personal ownership of capital stock, was at all of the times herein mentioned the owner of, and in control of the said corporations, which said corporations, among other similarly owned and controlled, are named as follows, to wit: • • •

"Consensus Publishing Company of Illinois."

28. Annenberg was named as a defendant in this case. The indictment does not charge that these defendants were the owners of this stock but in effect charges that the defendants (including Annenberg) "would be and were the owners and holders of beneficial interests for themselves and others in said corporation.

Hyland testified that he examined the bank accounts and the personal checks of the defendants (other than the checks of Ragans) to determine what disposition was made of these payments charged as commissions. The obvious purpose of his checking the disposition of these commissions was an attempt to find evidence that the payment of these sums to defendants were at least in part fictitious in that a portion thereof was being turned back to Annenberg. If this were true, obviously such sums would constitute dividends to Annenberg. There was no evidence to this effect.

## APPENDIX III.

Revenue Act of 1932, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

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SEC. 145. PENALTIES.

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(b) Any person required under this title to collect, account for, and pay over any tax imposed by this title, who willfully fails to collect or truthfully account for and pay over such tax, and any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than five years, or both, together with the costs of prosecution.

* * * * * *

Revenue Act of 1934, 48 Stat. 680:

Section 23 (a) is identical with Section 23 (a) of the Revenue Act of 1932 above quoted. (U. S. C., Title 26, Sec. 23.)

Section 145 (b) is identical with Section 145 (b) of the Revenue Act of 1932 above quoted. (U. S. C., Title 26, Sec. 145.)

Revenue Act of 1936, 49 Stat. 1648:

Section 23 (a) is identical with Section 23 (a) of the Revenue Act of 1932 above quoted.

Section 145 (b) is identical with Section 145 (b) of the Revenue Act of 1932 above quoted.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 126. *Compensation for personal services.*— Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. • • •

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

Article 23 (a)-6 is identical with Article 126 of Treasury Regulations 77 above quoted.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Article 23 (a)-6 is identical with Article 126 of Treasury Regulations 77 above quoted.